

# Leverage and its Impact on Earnings and Share Price

A Special Reference to listed Companies of Colombo Stock Exchange (CSE) in Sri Lanka

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**Abstract** - This study investigates the impact of leverage on earnings and share price of listed companies on Colombo Stock Exchange (CSE) in Sri Lanka. The study was identified 20 companies listed on the CSE for the period from year 2007/2008 to 2011/2012. The Degree of Operating Leverages (DOL), Degree of Financial Leverage (DFL) & Degree of Combined Leverage (DCL) are the independent variables and Earning Per Share (EPS) and Share Price (SP) are the dependent variables for this study. The present study used the correlation coefficient and linear regression to measure the variables. The findings revealed that only 4% earnings can be explained by DOL, DFL and DCL and there is no significant relationship with EPS. It is also found that 3% SP is attributed by DOL, DFL and DCL and there is no significant relationship with SP. Thus, fixed operating expenses and the financing mix decisions of the firm are not significantly impact the earning capacity of the listed companies in CSE.

**Keywords:-** Leverage; Earnings per Share (EPS); Share Price (SP).

## I. INTRODUCTION

The proportionate mix of equity and debt in financing a firm's investment proposals has been the subject of intensive theoretical modelling and empirical examination over the years having its tenet in the implication of such a mix on corporate performance. The mix has been defined in terms of capital structure in the literature Grinblatt & Titman, (2003), Pandey, (2008). Capital structure is seen as the mix of debt and equity. The capital structure decision reflects judgment and the assessment of a highly uncertain future management degree of risk aversion and may affect the firm's financial policy. Thus, the change in capital structure that is caused by an increase or decrease in the ratio of debt to equity is referred to as financial leverage. When a firm includes debt as a proportion of funds employed to finance its project, financial leverage is brought into being.

All firms face three types of risk Moyer, McGuigan & Kretlow, (2005). The three levels of risk are business risk, financial risk and combined risk. Business risk can be defined as the variability in a firm's operating profit, often referred to as Earnings Before Interest and Taxes (EBIT), over time and is generally attributable to the inherent nature of the firm's operations and the environment within which it operates. This type of risk is driven primarily by the firm's cost structure, product demand characteristics and intra-industry competitive position. Some companies may face high business risk solely because of external, and therefore largely uncontrollable,

factors such as high-fixed costs, the cyclical nature of its business, government regulation and intense competition. However, high business risk can also be the result of poor cost controls, low productivity or pricing practices which dilute revenues. Moyer, McGuigan & Kretlow, (2005) suggested that the important measure of a firm's business risk is s DOL.

Financial risk is generally defined as the added variability in earnings available to a firm's common shareholders due to the use of debt to finance the acquisition of assets. It often represents the increased probability of insolvency that comes with excessive debt finance because interest on debt must be paid. High financial risk may indicate that high interest charges are overwhelming a business enterprise, forcing it in some cases to seek court protection. Financial risk, unlike business risk, is not the product of the environment within which a company operates. Rather it results directly from a firm's conscious decision to use financial leverage instead of issuing common stock to raise funds.

Combined risk refers to the risk that results from the interaction of both operating and financial risk. It is important to note that the interaction of the two risk types has a multiplicative, rather than an additive, effect. The impact of the combined effect can be extremely powerful.

Much of the existing literature focuses on the macroeconomic problems of the economies. Micro analysis, focusing on the firm level analysis is still felt missing. Particularly the space is felt in the literature regarding analysis of the behavior of leverage at the firm level. Specifically, few studies in developing countries are in this direction. In Sri Lanka, few attempts have been made to verify leverage and impact on EPS and SP. Therefore, this study is to examine leverage and its impact on EPS and SP of a listed companies in Sri Lanka.

## II. OBJECTIVES OF THE STUDY:

The following objectives has been taken for the study

- To analyze the impact of leverage on EPS and SP of the sample listed companies in Sri Lanka.
- To identify the relationship between leverage and EPS.
- To assess the relationship between leverage and SP

### III. LITERATURE REVIEW AND THEORETICAL DISCUSSION

**Leverage** - The employment of asset or source of funds for which the firm has to pay fixed cost or fixed return is termed as leverage. The asset or source of fund is act as force to boost up the firm's ability to increase the profitability. The higher leverage obviously implies higher outside borrowings and hence it is riskier if the firms earning capacity is reduced. In other words, only when the Return on Investment is higher than the cost of outside borrowing, the effect of leverage will be favorable.

**Operating leverage** - Operating leverage affects a firm's operating profit. The DOL is defined as the percentage change in the EBIT relative to a given percentage change in sales. EBIT depends on sales. A change in sales will affect EBIT. The variability in EBIT due to a change in sales is affected by the composition of fixed and variable costs. You may recall that the percentage change in EBIT occurring due to a given percentage change in sales is referred to as the DOL.  $DOL = \text{Percentage change in EBIT} / \text{Percentage change in sales}$ .

**Financial leverage** - Financial leverage measures firm's exposure to the financial risk. The use of the fixed-charges sources of funds, such as debt and preference capital along with the owners' equity in the capital structure, is described as financial leverage, gearing, or trading on equity. The financial leverage employed by a company is intended to earn more return on the fixed-charge funds than their costs. The surplus (or deficit) will increase (or decrease) the return on the owners' equity. The rate of return on the owners' equity is levered above or below the rate of return on total assets. The percentage change in EPS occurring due to a given percentage change in EBIT is referred to as the DFL.  $DFL = \text{Percentage changes in EPS} / \text{Percentage changes in EBIT}$ .

**Combine leverage** - Operating and financial leverages together cause wide fluctuation in EPS for a given change in sales. It can be done by multiplying the operating leverage and financial leverage. The operating leverage affects the EBIT and the financial leverage affects the EPS. The management has to devise a right combination of the operating and financial leverage. A company whose sales fluctuate widely and erratically should avoid use of high leverage since it will be exposed to a very high degree of risk

**Leverage and EPS** - There is a close relationship between the financial leverage and EPS of the company. If DOL is high and the return on investment is greater than the cost of debt capital, then the impact of leverage on EPS will be favourable. The impact of financial leverage is unfavourable when the earning capacity of the firm is less than what is expected by the lenders.

**Leverage and SP** - The market value per share of a company is an indication of the value of the company. It is only a temporary metric based on the current stock market. The true value of the company i.e., its profits, product positioning, balance sheet, etc. may not be reflected in the market value per share. On the other hand, a company can be doing well, but still have a low market value per share.

Franklin & Muthusamy, (2011) confirmed that the financial leverage is a prerequisite for achieving optimal capital structure. An optimal capital structure can influence the value of firm and wealth of shareholder's through reduced cost of capital. Hence, determination of optimal debt level and its

impact on the firm's over all capital structure is regarded as an integral part of a firm's financial decision. Financial leverage, or an increase in financial efficiency, called the variation of return on equity, depends on the return on assets and the cost of credit i.e., interest rate. Brezeanu, (1999) stated that the financial leverage also expresses the impact of financial expenses due to loans on the return on equity of an enterprise.

Financial leverage can accelerate EPS under favourable economic conditions but depresses EPS when the economic goings is not good at economy and for the firm. The unfavourable effect of financial leverage on EPS is more severe with more debt in the capital structure when EBIT is negative. Similarly, financial leverage can increase shareholders' return and as well can increase the firm's risk also. The financial leverage employed by a firm is intended to earn more on the fixed charges funds than their relative costs Pandey, (2007).

Jensen & Meckling, (1976) identified that there has been a movement away from the traditional tax-bankruptcy cost argument toward a consideration of agency costs as the major determinant of financial leverage. It was showed that with risky debt outstanding, a firm's investment policy is not fixed. It was recognized that the underinvestment problem by noting that shareholders of firms with risky debt will invest only when or up to the point at which, the expected return on investment is at least as great as the promised payment to bondholders. When the expected return is less than the promised payment, shareholders fail to exercise the investment option or invest less than the optimal amount, which reduces firm value. It is this decline in firm value which limits the amount of debt a given firm can issue Myers, (1977).

Mandelkar, & Rhee, (1984) point out that the DOL and DFL combine to magnify a given percentage change in sales to a potentially much greater percentage in EBIT. Operating and financial leverages together cause wide fluctuation in EPS for a given change in sales. If a company employs a high level of operating and financial leverage, even a small change in the level of sales, will have dramatic effect on EPS

A high level of financial leverage allows shareholders to obtain a high return on equity, but they are also exposed to a higher risk of significant loss if the return on assets is low. Also, using loans may lead to restricting the independence of the company's management, and creditors are interested in the indebtedness of the company. Financial leverage is combined with the operating leverage. The combined effect is equal to the product of the operating and financial leverage Nicoleta, (2010). The variables sales, interest, cash flow, asset structure, interest coverage, firm's size, retained earnings, earnings before interest and tax and intrinsic value of shares influence financial leverage Franklin & Muthusamy, (2011).

### IV. HYPOTHESIS OF THE STUDY

For better understanding the impact of leverage on the EPS and SP, the following hypothesis can be framed.

**Hypotheses 01 - Ho:** The DOL position of the listed companies in CSE does not differ significantly.

**Hypotheses 02 - Ho:** The DFL position of the listed companies in CSE does not differ significantly.

**Hypotheses 03 - Ho:** The DCL position of the listed companies in CSE does not differ significantly.

**Hypotheses 04 - H<sub>1</sub>:** DOL is significantly correlated with EPS.

**Hypotheses 05 - H<sub>1</sub>:** DFL is significantly correlated with EPS.

**Hypotheses 06 -H<sub>1</sub>:** DCL is significantly correlated with EPS.

**Hypotheses 07 – H<sub>1</sub>:** DOL is significantly correlated with SP.

**Hypotheses 08 – H<sub>1</sub>:** DFL is significantly correlated with SP.

**Hypotheses 09 – H<sub>1</sub>:** DCL is significantly correlated with SP.

**Hypotheses 10 – H<sub>1</sub>:** There is a significant effect of leverage on EPS.

**Hypotheses 11 –** There is a significant relationship between leverage and SP.

## V. METHODOLOGY

**Research Design:-**The present study adopts an analytical and descriptive research design. The emphasis here is on studying a situation or a problem in order to explain the relationship between variables. The study aims to understand and analyze the leverage effects on EPS and SP of sample companies by using statistical tools.

**Sampling techniques and population;-** At present, more than 285 companies are listed under the 20 sectors on CSE. Twenty companies were selected randomly for the purpose of study.

**Data type and Sources:-**The study was used secondary data. This data was collected from the annual reports of sample companies. In addition to the above data was collected from research studies, books and journals. The collected data was processed and analyzed in order to make the study useful to the researchers, planners, policy makers and academicians.

**Period of the study;-**The study was covered the period from 2007/ 2008 to March 2011/2012.

**Reliability and Validity of the data;-**Secondary data for the study was collected from audited accounts (i.e., income statements and balance sheets) of the concerned companies as fairly accurate and reliable. Therefore, these data may be considered reliable for the study. Necessary checking and cross checking were done while scanning information and data from the secondary sources. All these efforts were made in order to generate validity data for the present study. Hence, researcher satisfied content validity.

### Variables:

**Dependent Variables:** The dependent variables are EPS & SP and **Independent Variables:** The independent variables are DOF, DFL and DOL.

**Mode of Analysis;-**In the present study analyzed the collected data by descriptive statistics (i.e., means, maximum, minimum and standard deviation) inferential statistics (i.e. pierson's correlation and simple regression). The results were got by applied the SPSS 16.

$$EPS_i = b_0 + b_1 DOL + b_2 DFL + b_3 DCL + E_i \quad (1)$$

$$SP_i = b_0 + b_1 DOL + b_2 DFL + b_3 DCL + E_i \quad (2)$$

## VI. DATA ANALYSIS

TABLE I. DESCRIPTIVE STATISTICS OF THE SAMPLE

	Descriptive statistics of the sample				
	N	Minimum	Maximum	Mean	Std. Deviation
DOL	100	26.18	17.53	0.97	7.58
DFL	100	-18.91	31.49	1.71	5.62
DCL	100	-134.93	61.04	2.25	18.27
EPS	100	-14.73	31.18	6.13	8.03
SP	100	5.15	1999.00	1.15	218.19

Source: Author constructed

Note: N =100 -20 companies for 5 years

From the above table 1 it is clear that the DOL, DFL and DCL show a fluctuating trend based on the mean and standard deviation values of sample companies. The standard deviation of DFL is 5.62 which is higher volatility. Therefore, the firm's inability to make profit during the period. The standard deviation of DOL is 7.58 comparatively high which indicates that the company more risky in terms the operating risk.

### A. Hypotheses 01

**Ho:** The DOL position of the listed companies in CSE does not differ significantly.

TABLE II. DOL OF THE SAMPLE LISTED COMPANIES

	DOL of the sample listed companies				
	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	6366.64	96	66.31	9.77	0.042
Within Groups	20.37	3	6.790		
Total	6387.01	99			

Source: Author constructed

Note: One-way ANOVA has been performed in SPSS

The P- value is 0.042, which is less than 0.05, the null hypothesis is rejected. It is concluded that the DOL position of listed companies in CSE differs significantly.

### B. Hypotheses 02

**Ho:** The DFL position of the listed companies in CSE does not differ significantly.

TABLE III. DFL OF THE SAMPLE LISTED COMPANIES

	DFL of the sample listed companies				
	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	4791.91	81	59.15	0.66	0.88
Within Groups	1595.09	18	88.61		
Total	6387.01	99			

Source: Author constructed

Note: One-way ANOVA has been performed in SPSS

P value is 0.888, which is greater than 0.05, the null hypothesis is accepted. Hence, it is concluded that the DFL position of listed companies does not differ significantly.

### C. Hypotheses 03

**H<sub>0</sub>:** The DCL position of the listed companies in CSE does not differ significantly.

TABLE IV. DCL OF THE SAMPLE LISTED COMPANIES

	DCL of the sample listed companies				
	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	6343.98	97	65.40	3.03	0.28
Within Groups	43.03	2	21.51		
Total	6387.02	99			

Source: Author constructed

Note: One-way ANOVA has been performed in SPSS

P- value is 0.280, which is greater than 0.05, the null hypothesis is accepted. Hence, it is concluded that the DCL position of listed companies does not differ significantly.

### Correlation Analysis

Correlation analysis is an important statistical tool which helps in determining the relationship between two or more variables .

### D. Hypotheses 04

**H<sub>1</sub>:** DOL is significantly correlated with EPS.

TABLE V. RESULTS OF THE CORRELATION ANALYSIS

Results of the correlation analysis						
		DOL	DFL	DCL	EPS	SP
DOL	Pearson Correlation	1	.014	.364**	-.035	-.043
	Sig. (2-tailed)		.892	.000	.726	.673
DFL	Pearson Correlation	.014	1	-.121	-.038	.002
	Sig. (2-tailed)	.892		.230	.709	.981
DCL	Pearson Correlation	.364**	-.121	1	.167	.019
	Sig. (2-tailed)	.000	.230		.097	.852
EPS	Pearson Correlation	-.035	-.038	.167	1	.255*
	Sig. (2-tailed)	.726	.709	.097		.010
SP	Pearson Correlation	-.043	.002	.019	.255*	1
	Sig. (2-tailed)	.673	.981	.852	.010	

\*\* . Correlation is significant at the 0.01 level (2-tailed).

\*. Correlation is significant at the 0.05 level (2-tailed).

Table 5 spot that the correlation between the DOL and EPS is weak negative correlation which point out that the DOL can negatively affected the EPS. As per the 'Significant' test

results, it is clear that the correlation is insignificant at the 0.01 level (2-tailed) and 0.05 level of sample listed companies in CSE. Therefore, hypothesis is rejected. Hence, there exists insignificant relationship between DOL and EPS.

### E. Hypotheses 5

**H<sub>1</sub>:** DFL is significantly correlated with EPS.

Table 5 indicates that the correlation between the DFL and EPS is weak negative correlation which summit that the DFL can negatively affected the EPS. As per the 'Significant' test results, it is clear that the correlation is insignificant at the 0.01 level (2-tailed) and 0.05 level of sample listed companies in CSE. Therefore, hypothesis is rejected. Hence, there exists insignificant relationship between DFL and EPS.

### F. Hypotheses 06

**H<sub>1</sub>:** DCL is significantly correlated with EPS.

Table 5 specifies that the correlation between the DCL and EPS is weak positive correlation which point out that the DCL can positively affected the EPS. As per the 'Significant' test results, it is clear that the correlation is insignificant at the 0.01 level (2-tailed) and 0.05 level of listed companies in CSE. Therefore, hypothesis is rejected. Hence, there exists insignificant relationship between DCL and EPS.

### G. Hypotheses 07

**H<sub>1</sub>:** DOL is significantly correlated with SP.

Table 5 denotes that the correlation between the DOL and SP is weak negative correlation which point out that the DOL can negatively affected the SP. As per the 'Significant' test results, it is clear that the correlation is insignificant at the 0.01 level (2-tailed) and 0.05 level of listed companies in CSE. Therefore, hypothesis is rejected. Hence, there exists insignificant relationship between DOL and SP.

### H. Hypotheses 08

**H<sub>1</sub>:** DFL is significantly correlated with SP.

Table 5 specifies that the correlation between the DFL and SP is weak positive correlation which reveals that the DFL can positively affect the SP. As per the 'Significant' test results, it is clear that the correlation is insignificant at the 0.01 level (2-tailed) and 0.05 level of listed companies in CSE. Therefore, hypothesis is rejected. Hence, there exists insignificant relationship between DFL and SP.

### I. Hypotheses 09

**H<sub>1</sub>:** DCL is significantly correlated with SP

Table 5 specifies that the correlation between the DCL and SP is weak positive correlation which position that the DCL can positively affected the SP. As per the 'Significant' test results, it is clear that the correlation is insignificant at the 0.01 level (2-tailed) and 0.05 level of listed companies in CSE. Therefore, hypothesis is rejected. Hence, there exists insignificant relationship between DCL and SP.

### Regression analysis

#### J. Hypotheses 10:

**H<sub>1</sub>:** There is a significant effect of leverage on EPS

$$EPS = 6.077 - 0.117 \cdot DOL - 0.016 \cdot DFL + 0.090 \cdot DCL \quad (1)$$



TABLE VI. MODEL SUMMARY OF THE SAMPLE

Model Summary of the sample				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.197 <sup>a</sup>	0.039	.009	7.99732

Predictors: (Constant), DCL, DFL and DOL

Correlation of DOL, DFL and DCL with EPS is weak positive correlation. R squared is the proportion of variation in the dependent variable explained by the regression model. When we consider the coefficient of determination ( $R^2$ ) between overall DOL, DFL and DCL with EPS is 0.039. This shows 4% variance in EPS is attributed by DOL, DFL and DCL. 96% of the variation is explained by other factors determining the EPS and the overall fitness of the model is very low.

TABLE VII. ANOVA<sup>b</sup> OF THE SAMPLE

ANOVA <sup>b</sup> of the Sample					
Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	247.13	3	82.37	1.28	0.283 <sup>a</sup>
Residual	6139.88	96	63.95		
Total	6387.02	99			

Predictors: (Constant), Degree of Combined Leverage, Degree of Financial Leverage, Degree of Operating Leverage  
Dependent Variable: Earning Per Share

Table. 7 indicate P- value is small (smaller than say 0.05) then the independent variables do a good job explaining the variation in the dependent variable. The P- value is 0.283, which stated that EPS cannot be explain by DOL, DFL and DCL. This implies that there is no significant effect of leverage on EPS.

$H_{11}$ : There is a significant effect of leverage on SP.

$$\text{Share Price} = 6.077 - 0.117 \cdot \text{DOL} - 0.016 \cdot \text{DFL} + 0.090 \cdot \text{DCL}$$

TABLE VIII. MODEL SUMMARY OF THE SAMPLE

Model Summary of the sample				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.057 <sup>a</sup>	.003	-.028	221.22125

Predictors: (Constant), DCL, DFL and DOL

Correlation of DOL, DFL and DCL with SP is weak positive correlation. When we consider the coefficient of determination ( $R^2$ ) between overall DOL, DFL and DCL with SP is 0.003. This shows SP is not attributed by DOL, DFL and DCL.

TABLE IX. ANOVA<sup>b</sup> OF THE SAMPLE

ANOVA <sup>b</sup> of the Sample					
Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	15340.543	3	5113.514	0.104	0.957 <sup>a</sup>
Residual	4698128.833	96	48938.842		
Total	4713469.375	99			

Predictors: (Constant), Degree of Combined Leverage, Degree of Financial Leverage, Degree of Operating Leverage  
Dependent Variable: Earning Per Share

Table 9. The P-value is 0.957, which stated that SP cannot be explain by DOL, DFL and DCL. This implies that there is no significant effect of leverage on SP.

## V. DISCUSSION AND CONCLUSION

**Operating leverage;**It is found that the DOL position of listed companies in CSE differ significantly. The correlation between DOL with EPS and SP is weak negative correlation in sample listed companies during the study period. And there is no significant relationship between DOL and EPS as well as SP.

**Financial Leverage;**It is found that the DFL position of listed companies does not differ significantly. The correlation between DFL and EPS is weak negative correlation in sample listed companies during the study period. And also the correlation between DFL and SP is weak positive correlation in sample listed companies during the study period. It's found that there is no significant relationship between DFL and EPS as well as SP.

**Combined leverage;**It is create that the DCL position of listed companies does not differ significantly. The correlation between DCL and EPS is weak positive correlation in sample listed companies. And also the correlation between DCL and SP is weak positive correlation. There is no significant relationship between DCS and EPS as well as SP during the study period.

**Earnings per share;**It is found that the mean value of EPS of listed companies in CSE is Rs.6.13. It is an indication of positive earnings per share of the listed companies in CSE. The standard deviation of EPS of listed companies is a high variation in its EPS during the study period. There is no significant effect of leverage on EPS.

**Share Price;**The standard deviation of listed companies on CSE is 218.19 that there is a high variation (Volatility) in its SP during the study period. The SP is not attributed by DOL, DFL and DCL. The results implies that leverage is not significantly effect on SP

From the study it is found that there is no significant relationship between DOL and EPS, DFL and EPS, DCL and EPS, DOL and SP, DFL and SP and DCL and SP. Thus, fixed operating expenses and the financing mix decisions of the firm are not significantly affect the earning capacity of the listed companies in CSE. However, this study failed to support the hypothesized positive relationship between financial leverage and both measures. It was also hypothesized that highly leveraged companies are riskier in terms of their return on equity and investment. The results indicated that high leveraged firms were less risky in both market-based and accounting-based measures, which is the opposite of hypothesis two.

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#### APPENDIX

S.No	Company name	CSE code
01	Cargills (ceylon) PLC	CARS
02	Acl cables PLC	ACL
03	Dialog axiata PLC	DIAL
04	Balangoda plantations PLC	BALA
05	Acme printing & packaging PLC	ACME
06	Convenience foods (lanka )PLC	SOY
07	Taj lanka hotels PLC	TAJ
08	Sathosa motors PLC	SMOT
09	Trans asia hotels PLC	TRAN
10	Colombo dockyard PLC	DOCK
11	Ceylon leather products PLC	CLPL
12	Lanka milk foods (cwe) PLC	LMF
13	Coco lanka PLC	COCO
14	John keells PLC	JKL
15	Singer industries (ceylon) PLC	SINI
16	Dipped products PLC	DIPD
17	Horana plantations PLC	HOPL
18	Ceylon cold stores PLC	CCS
19	Keells food products PLC	KFP
20	Ceylon beverage holdings PLC	BREW